SELVI
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THE FINANCIAL LETTER

REVIEW, OPINIONS AND MARKETS' PERSPECTIVES

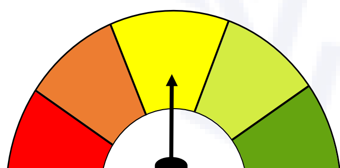
SUMMER 2024

Investment context

The economic and geopolitical contours of the new post-pandemic regime are slowly beginning to emerge. The task of political leaders and central bankers will be particularly complex over the next few years. The ongoing global geopolitical recession will continue with the looming / critical issue of US elections.

The likelihood of ultra profligate policies, fiscal dominance, central bank cooperation/collusion and ultimately higher inflation remains elevated. The market party may continue as long as nominal growth is robust and global liquidity ample.

Expect better visibility and the end to regimes' transition from 2025



Main indicators in 2024
(on June 30th)

Indicators	Variation %
Eurostoxx 50	+8.2
Swiss Market Index	+7.7
FTSE 100	+5.6
S&P 500	+14.5
Short-term rate EUR	3.7
Short-term rate USD	5.5
EURUSD	-2.9
EURCHF	-3.5
Barclays Euro Bonds	-1.2
Barclays US Bonds	-3.1

¨Secular¨ Disruptions

- Climate / War efforts
- Technology / AI
- Inequalities

De-globalization

- Trade
- Re-onshoring
- De-dollarization

(Geo)-Politics

- New Multipolar World Order
- Emergence of Global South
- War at EU doorsteps

Economic Policies

- Sustainbility of positive real rates
- War economy
- From Wealth Effect to what?
- Central bank digital currenciers
- Debt Sustainability (Minsky)

Investment framework

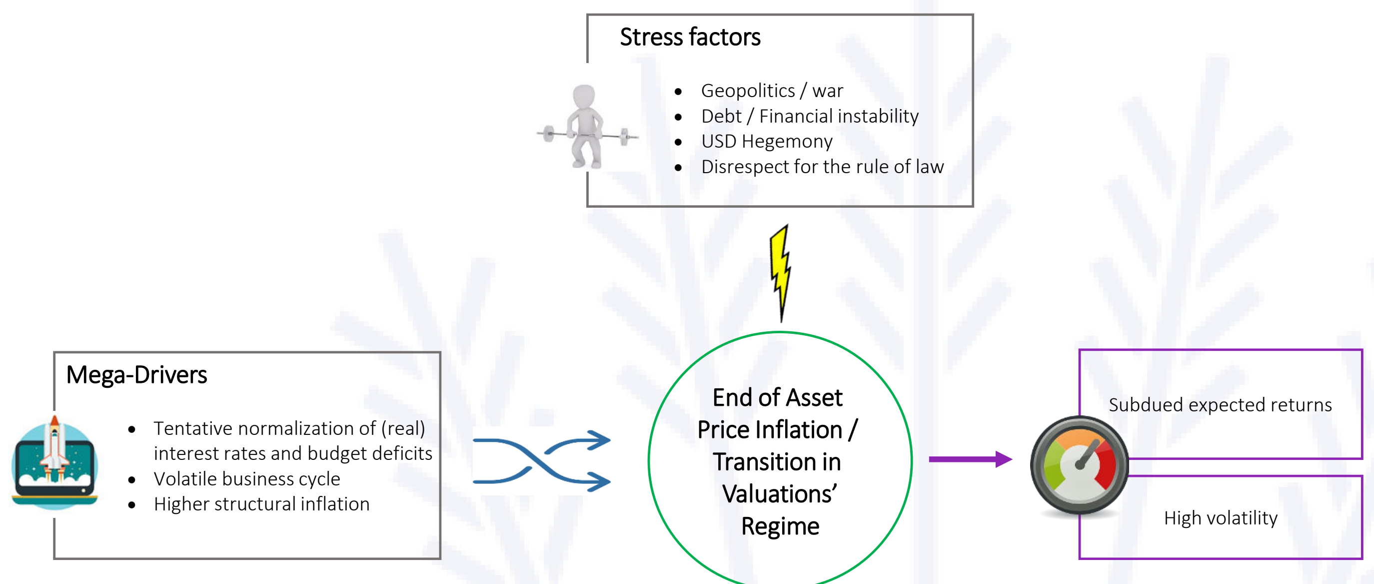
Global Macro perspectives remain quite benign in 2024. Risks of a recession have diminished. Though not definitely tamed, inflation is no longer running away. This should prove a resurging issue next year.

The Japanese currency / sovereign bonds' ticking bomb is unlikely to explose shortly, courtesy of lower growth and very risk averse BoJ / government.

While a US sovereign debt crisis is unlikely in the short term, a ¨Liz Truss-like moment¨ will eventually occur over time. It seems premature to divest from financial markets because of this medium-term perspective. Indeed, such an outcome will be preceded by a market-friendly - generous - injection of liquidity.

Dire geopolitics must be as little as possible taken into account when taking strategic investment decisions. This is easier said than done in the current context!

Regime in transitions



Long-term drivers

We consider **three secular disruptors.** 1)*Climate* change. Climate disorders spikied because of El Niño. It tends to reinforce inflation. 2) *Technology.* The secular digitalisation and AI are transformational. This is a fundamentally disinflationary process that will ultimately improve productivity. 3) Macro-*Inequalities*. Financial repression aggravated it. Pandemic and LT economic drivers mark a sea-change as adverse demography, lower labor mobility, and societal factors (Great Resignation), reshoring reinforce labor. Increasing the bargaining power of labor is politically welcome, but inflationary through wages.

Deglobalization. BRICS / Global South are joining for a new Trade settlement order (Yuan, gold, etc.). *De-dollarization* is accelerating, and gold revival is for real.

(Geo)-Politics. The extremely tense situation on several fronts is likely to continue in the medium term. With the possible emergence of an Asian focus (North Korea, Taiwan). The outcome of the US elections is adding to the unpredictability. The disruption of the Red Sea shipping lanes or a Chinese embargo on Taiwan would bring back the problems of supply chains and rising commodity prices.

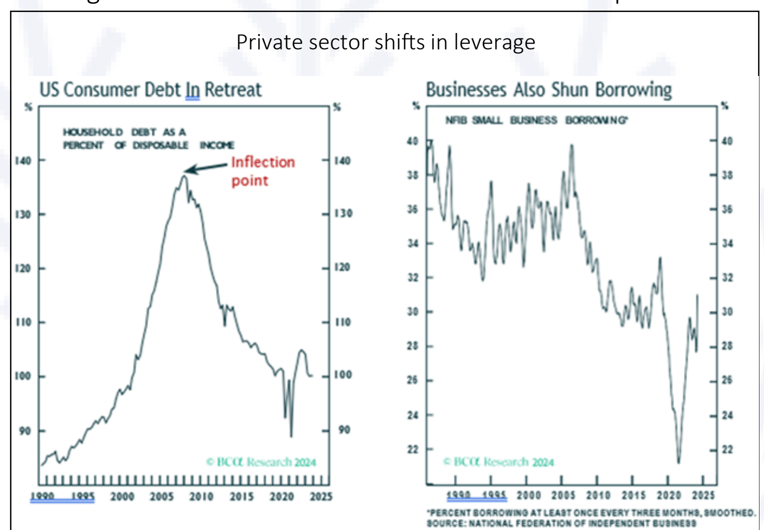
Economic Policies. US policy-makers have so far proven effective in containing contagion and mitigating the risks of a major breakdown / accident. Their measures, which look like financial engineering and time-saving, are temporary and technical. They provide no permanent solution. The problems of deficit and debt refinancing will return sooner or later, unless a new round of financial repression is imposed. In any case, volatility will resurface.

Medium term factors

Tipping points on the horizon

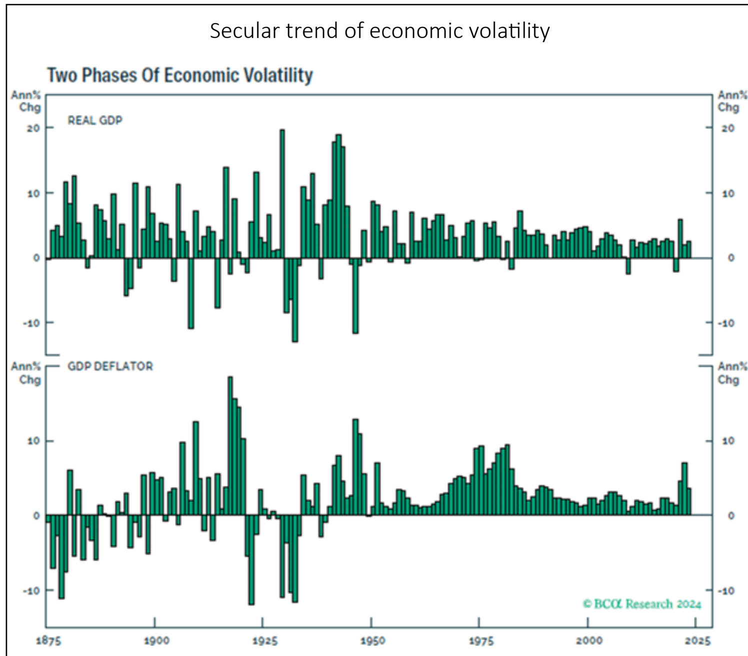
There have been three distinct phases in the evolution of global debt over time. Before the Great Depression of 1929-30, growth and inflation were very volatile. From then on, governments began to intervene to smooth out economic cycles. In particular, the years around the Second World War saw the nationalization of interest rates and capital controls in the US. Then regulation (banking) and social safety nets (unemployment benefits) growingly smoothed out cyclical shocks. As a result, cyclical excesses (debt, overcapacity, etc.) were much less pruned by natural market forces. According to Minsky theory, this macro stability a) set the stage

Private sector shifts in leverage



for the unbridled rise of private debt, from 80% of GDP in 1990 to 135% in 2008 until b) the GFC fuelled a - subsequent - dramatic deleveraging.

The government has gradually taken on debt from the private sector. US federal debt exploded from around $12tn in 2010 to $35tn in 2024. US government interest payments rose from around 2.5% of GDP between 2003 and 2021 to almost 4% now. Rising government debt is a drag on future GDP growth, more so when interest on the debt grows faster than the economy. For sure, it will eventually end it tears, but when?



In the UK in 2022, a too profligate government sounded the death knell to investors' confidence. A dramatic Liz Truss moment occurred, forcing the BoE to the rescue i.e. urgently injecting liquidity. In the US, limits to the government debt have not been reached yet. And the Fed could also restore calm in markets if needed. But a comeback of Trump would not clean the deficit/debt issues, quite the opposite.

Before the Great Depression, laissez-faire economic policies made growth and inflation very volatile

The inevitable burst of debt super-cycle would re-ignite higher economic volatility

Rarely have politics been this unstable

Autocratic regimes remain strong and show signs of greater cohesion (Russia, Iran, North Korea). As expected, the US electoral process is becoming more problematic and less predictable. The fragmentation of the French political landscape is also a cause for concern.

Western democracies have no choice but to pursue profligate economic policies. Ultimately, they will prefer inflation to austerity.

Real assets, precious metals and safe-haven assets/currencies will continue to thrive

Currencies

2024 began with consensus expectations of a weaker USD due to stretched valuations. However, year-to-date the dollar index has gained around 4.5%. The case for a weaker USD was based on deteriorating fiscal and trade deficits and a narrowing interest rate differential with other major economies. As the year unfolded, resilient growth and slower progress on inflation in the US pushed back rate cut expectations.

Meanwhile, other major central banks embarked on monetary policy easing ahead of the Fed. Consequently, the greenback gained broadly across all the currencies.

Over a slightly longer period, the USD index has been trading in a relatively tight range for more than a year. It is roughly a third below its 1985 all-time high, and it is even 7% below its more recent 2022 peak. While long-term fundamentals still indicate that the dollar is richly valued, higher-for-longer rates in the near term could continue to support a stronger-for-longer dollar.

The broader exchange rate does not appear egregiously expensive

The challenge of rate cuts to the USD

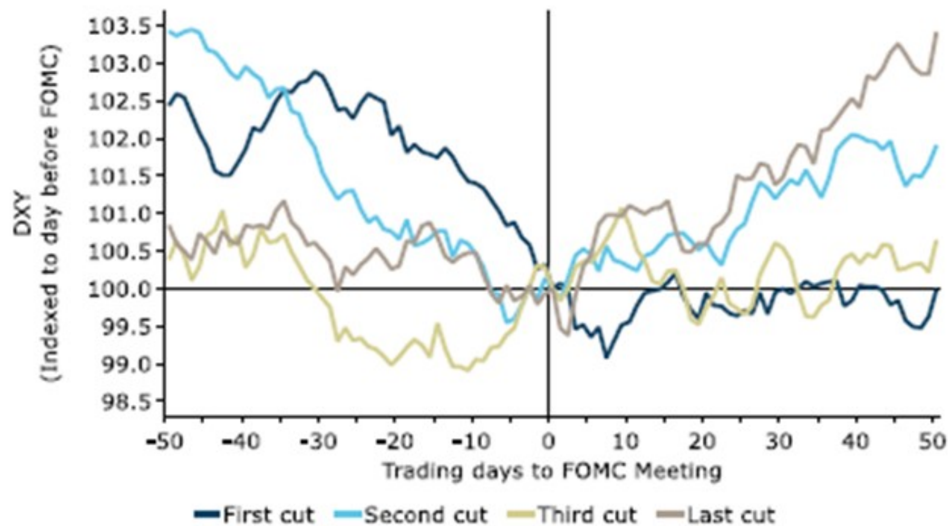
With conditions slowly moving closer to what the Fed needs to see before it initiates an easing cycle, focus is turning to the USD future performance. Despite easing from its 2022 high, the DXY is still 15% above its mid-2021 low. Despite false starts in 2023 and 2024, and according to the consensus, the market expects the USD to weaken towards 100 in 2025 once the Fed begins easing.

Three drivers

The Fed easing weighs on the USD, but its impact diminishes as the cycle progresses. Since 1990, the first cut in all cycles has had the largest negative impact on the USD. By the final rate cut of each cycle, the DXY was starting to rally after Fed meetings. Most of the DXY decline occurs in the lead-up to the 1st and 2nd meetings of the easing cycle.

Overall, the bulk of USD weakness occurs before the first couple of FOMC meetings

As easing cycles progress, cuts have less negative impact on the USD



Another factor is where the US economy is headed towards.

- Under hard landings (1990–1992, 2001–02, 2007–08 and 2020), we see a firmer USD, with initial weakness from rate cuts more than made up on haven demand.
- Under soft landings (1995–96, 1998, 2002–03 and 2019), the USD retains most of its weakness post the first rate cut.

In both landing scenarios, USD weakness is still largely frontloaded (softening data and Fed comments) ahead of the Fed easing cycles

A hard lending ultimately lifts the USD

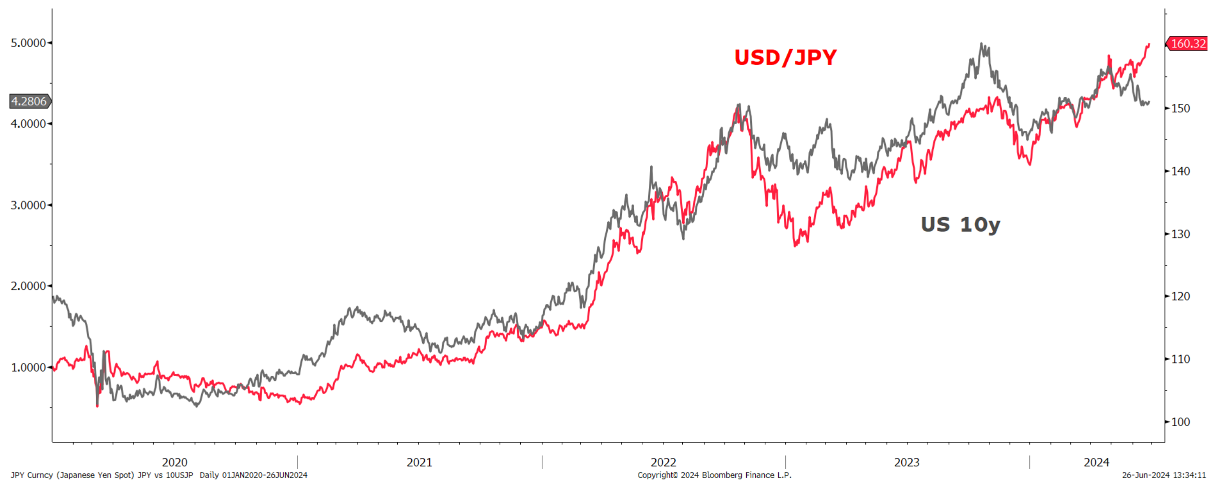
This easing cycle is further complicated by the US presidential election. There is no clear pattern in how a presidential election impacts the USD. A change in party seems to generate some short-term USD upside (ex-2020), but 1992 and 2016 aside, the boosts do not last long.

There is no real difference in short-term DXY performance around US presidential elections, whether it was in the context of an easing, holding or hiking cycles

Not moving in tandem anymore

The JPY tumbled to the weakest level since 1986, raising speculation authorities may act once again to support the currency. The Japanese currency fell beyond levels that last led officials to intervene in the market in April. Rhetoric from the Ministry of Finance in recent days has signaled increased concern.

Yield spread is totally disconnected



The yen looks set to retain its weak position. Higher inflation and more signs that wage growth is picking up should allow the BoJ to adopt a more hawkish stance at its July meeting. But like its rate hike in March, it may not have a big impact on the JPY. Recent intervention has failed to boost the currency but may have prevented it from falling further.

Whilst the MoF intervention in April/May has prevented USD/JPY from moving above 160, policymakers may still be forced to wait for the Fed to turn dovish and the USD to weaken to pull USD/JPY lower. When this happens, the JPY will be helped by the US-Japan 10-year yield spread as the pair is overvalued. Further, the speculative positioning remains extremely net short JPY.

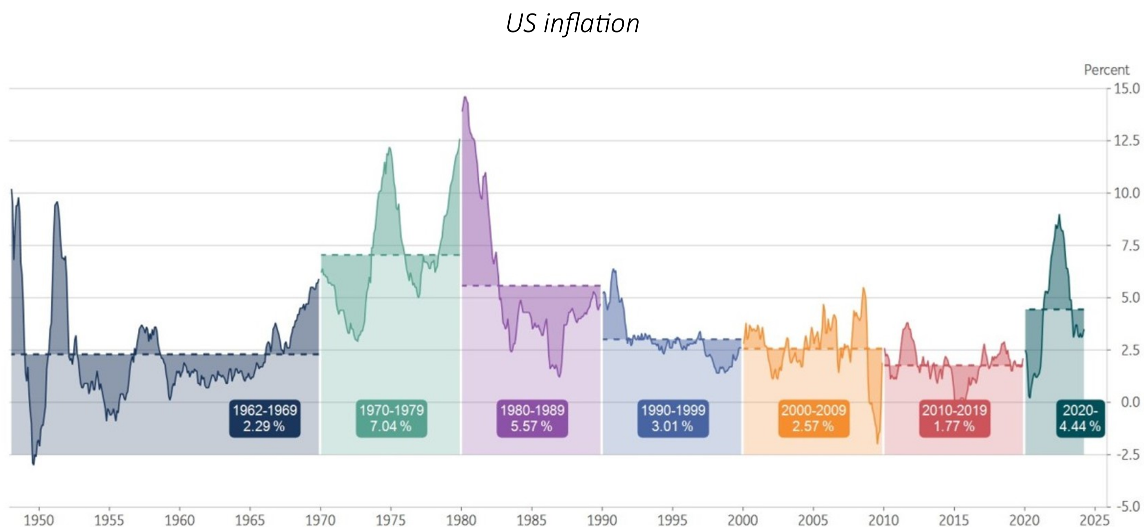
The positioning explains some of the JPY cheapness versus spreads. That position looks stretched, with limited scope to add to downside JPY bets

Bonds

Back to the noughties!

Which decade saw the level of inflation that would be broadly acceptable for the Fed? And then extrapolate.

US inflation



The 1950s and 1960s saw average inflation of 2.3%, which is very acceptable but quite far back. A better, more recent reference is the noughties which saw inflation averaging 2.5%.

Where was the Fed funds rate? It was averaging at 3%. We can work with from a theoretical neutral Fed Fund rate. It backs out an inflation expectation of 2.5% and a real rate of 0.5%. The neutral rate, neither restrictive nor stimulative, was 3%.

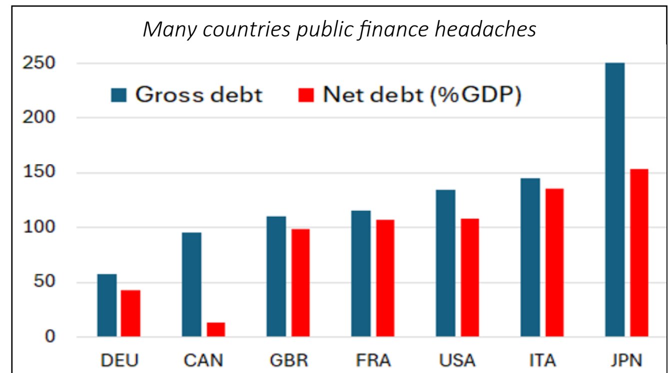
The US 10yr yield averaged 4.5% in the noughties. Broadly where we are today. This level feels high as we come through 15 years with an average 10yr yield of 2.5%. The 2.5% regime should be seen as the outlier.

We are currently at a more credible equilibrium level. Any shoot down to 4% or lower on rate-cut enthusiasm will be reversed within a matter of months, not years. Any fall in long tenor rates, as the Fed eventually cuts, are at risk for a swift reversal.

As inflation slows, the Fed cuts, the Treasury market rallies, and the 10yr can break back down towards 4% and below. But once the Fed gets a few cuts done and the market starts to view a bottom for the Fed Funds somewhere in the 3% to 4% range, then the 10yr yield can quickly back right up.
During the noughties, the Fed Funds averaged 3% and the 10yr 4.5%! Looking forward, it makes far more sense to view 4.5% as the more likely equilibrium level.

The fiscal challenges facing the US government are top of mind

The US federal government debt-to-GDP ratio is near its highest level since WWII, and the budget deficit larger than the past 50 years average, raising questions about the US public debt sustainability.

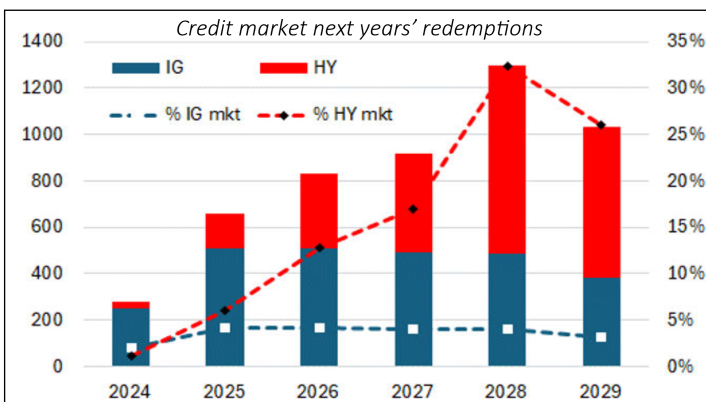


No one single metric can encapsulate a country's public finances. The US has a debt-to-GDP ratio near the G7 average. The public debt burden is larger in Japan and Italy but smaller elsewhere (Germany and Canada). The US is not much of an outlier. The current debt burden is not unprecedented, it was similar during and after WWII.

The good news is that the US government has some unique advantages. The USD is the world reserve currency and the largest and most diversified economy. The US Treasury market is the deepest and most liquid bond market. The Fed holds a smaller share of the debt relative to G7 central banks.

The US fiscal outlook is concerning given high debt levels by historical standards and large budget deficit relative to peers and history. Furthermore, net interest costs have climbed substantially. The problem is much more the sizable budget deficits outlook.
An aging population, elevated interest rates and heightened national security concerns will make fiscal consolidation a difficult task

No hurry about the credit maturity wall



Regular comments came back about the market impending maturity wall. While there is still $280bn of bonds maturing in 2024, and another $660bn in 2025, this should not be a source of stress for both IG and HY issuers.

These numbers account for less than 6% of the respective universe. The largest amount comes from the IG market.

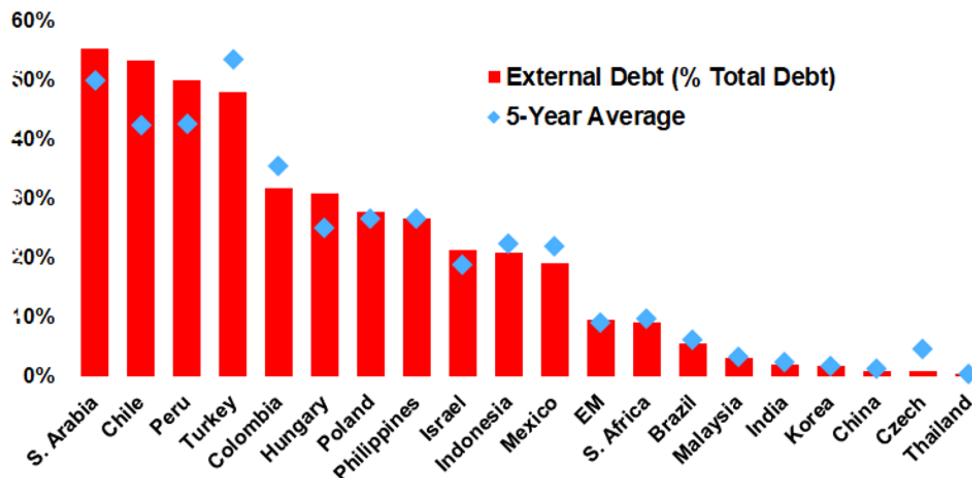
Thanks to 10 years of very low interest rates, corporates have been active in managing their maturities, tactically refinancing when lower rates were available. For sure, some low rated/ highly leverage credits may struggle to refinance their debt over the next 24 months. Indeed, we faced the same scenario last year, but 2023 did not come to a crashing end. Well-run companies that have steady free cashflow, moderate leverage and healthy interest cover ratios, should be able to afford higher financing costs.
Maturity wall is not an issue for credit issuers

EM sovereign debt surged

Robust hard-currency bond issuance has driven up external-debt ratios, exposing EM economies to greater risk. The outstanding stock of EM government debt surged to a record $18trn compared to a total US marketable debt of $27trn.

The total stock of EM sovereign debt climbed to a record, with hard-currency bonds representing a greater percentage of outstanding fixed-income obligations. Hard-currency debt from the 19 main EM issuers surged 90% since 2019 to $1.74trn, outpacing the jump in local-currency bond issuance. EM local-currency bonds are at an all-time high of $16.2trn, having expanded 64% since the pandemic.

External debt has risen in 8 of 19 main EM economies since the pandemic



The jump in hard-currency debt issuance has caused EM external-debt ratios to rise, leaving less-developed economies more tightly linked to financial conditions abroad. Only 3 economies have external obligations exceeding 50% of total debt, leaving them at greater risk of contagion than peers. External-debt ratios are above the 5-year average in 9 of the 19 main EM economies.

This situation leaves low-income countries less resilient to unexpected growth and inflation chocks

China remains uncorrelated

The yield on Chinese government bond fell to a more than 2 decade low. Investors continued to flock into amid lingering concerns about the domestic economy and expectations for further stimulus. The onshore 10-year yield slipped to 2.2%, the lowest since 2002. Yields on the 20- and 50- year bonds have been trading at their historic lows for months. The bonds have staged a sizzling rally on the back of China's lackluster economic growth, dovish monetary policy and the impact of ample liquidity in the banking system with loan demand so weak. China's central bank has been ramping up a verbal pushback against the bond rally and has hinted it may sell some of its own holdings to cool the advance. At one point, the PBoC will be concerned and may do something, including tighten front-end liquidity or even selling Chinese Government Bonds to slow the rates drop.

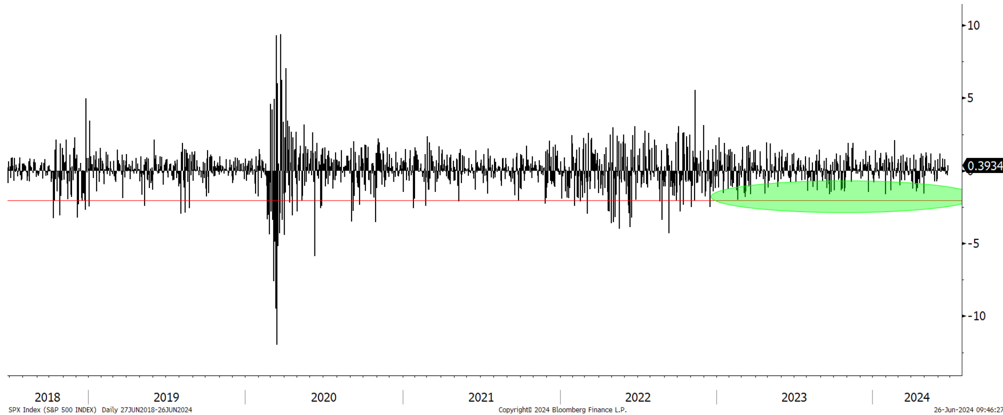
The PBoC is orchestrating this move as it fixed the yuan rate weaker . Chinese bond market rally has reached a limit

Equities

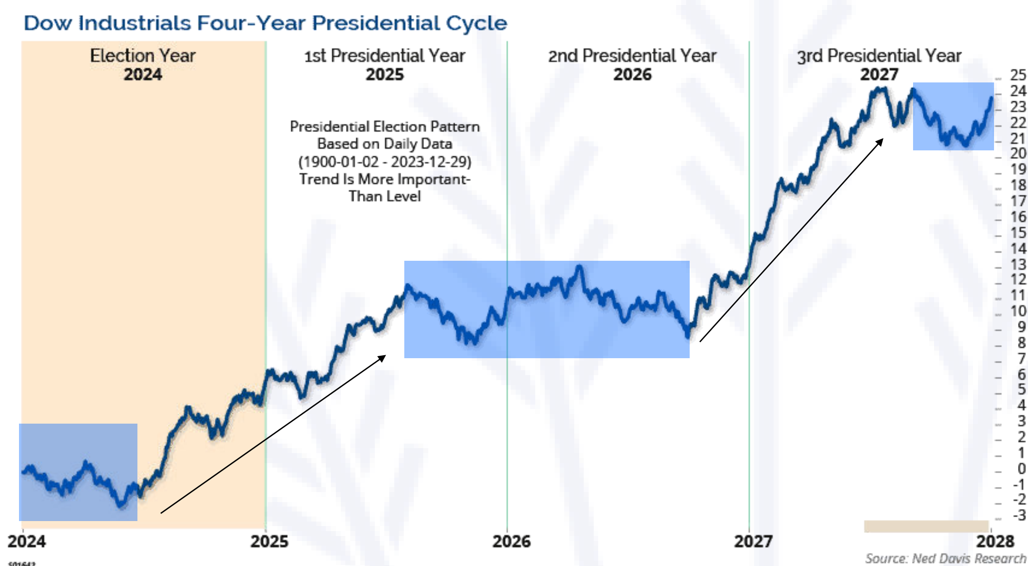
Anne, sister Anne, do you see anyone coming ?

Some investors are absolutely seeking to find THE factor that could derail this bull market. Some tried with the recession. Missed. With inflation. Missed. With geopolitics. Missed. With politics. Missed. With the valuations. Missed. With the Fed. Missed. The environment is definitely positive for stocks. The bull market is solid and is expected to continue beyond 2024. The S&P 500 has not seen declines greater than 2% since December 15, 2022, or 560 days. We must go back to the period May 2003–February 2007 when there were no drops greater than 2% for 1,378 days.

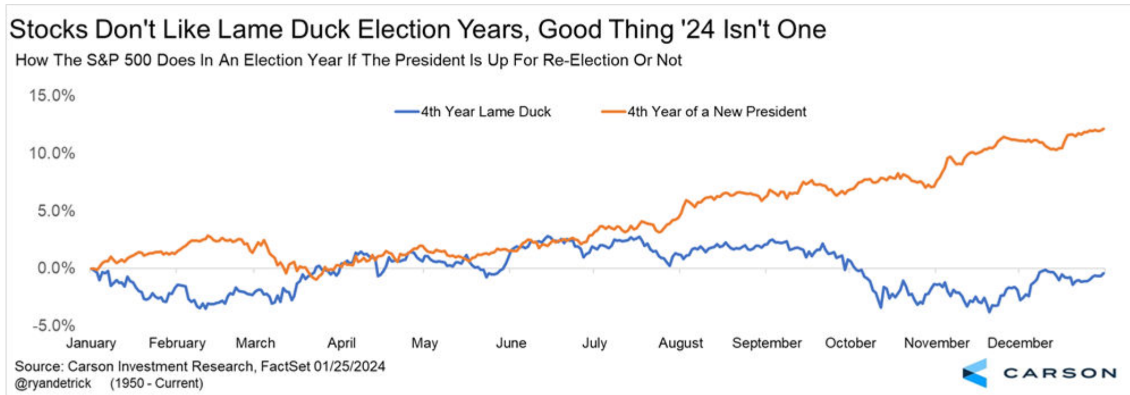
Daily movements of the S&P 500. Calm since December 2022



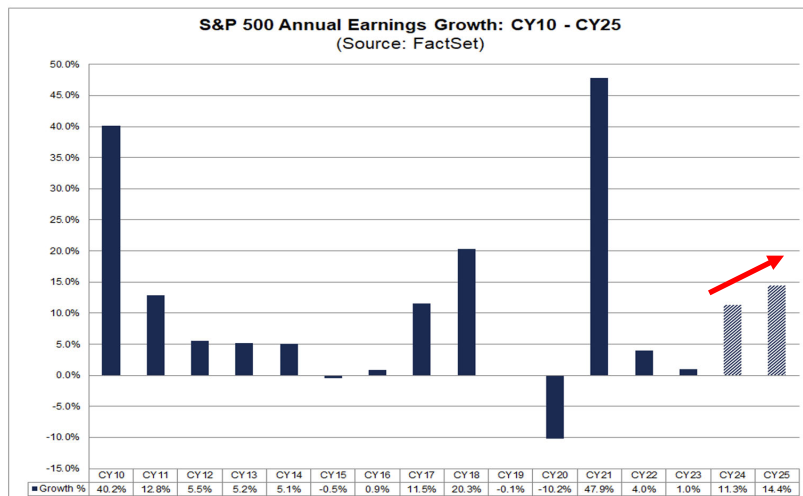
According to Bespoke, since 1929, the average duration of a bull market has been 3 years. This one has been going on for 1.6 years. So we are halfway there. The longest were those of 1987-2000 (12 years) and 2009-2020 (9.6 years), just before the crash linked to the Covid pandemic. Based on NDR's historical statistical data transposed on the current presidential cycle, the Dow Jones Industrial trend is expected to remain positive over the next 12 months. The trend is more important than the amplitude. Still according to NDR, the adage "Sell in May and go away" does not work in the year of an American presidential election. 78% of the time, between May 1 and the end of October, the S&P 500 performed positively.



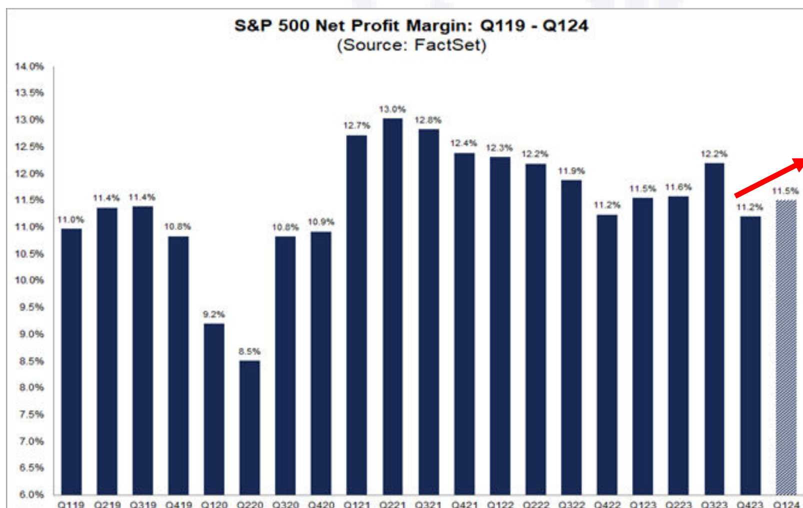
According to Carson Investment Research, with the exception of 1987, when the S&P 500 recorded a performance greater than 10% in the 1st quarter, the following 9 months were positive with an average increase of 7%. The progression is stronger (+12% on average) in the year of the presidential election unless the current president who is running is not popular. This is the case with Joe Biden because of his age and with young people because of his position vis-à-vis Gaza.



The resumption of the profit cycle and the strength of net margins, despite a chaotic environment since 2020, are also favorable for stocks. Certainly, the stock markets anticipated this trend, but as we are at the start of this cycle, there is no reason for the indices to exit this bull market.

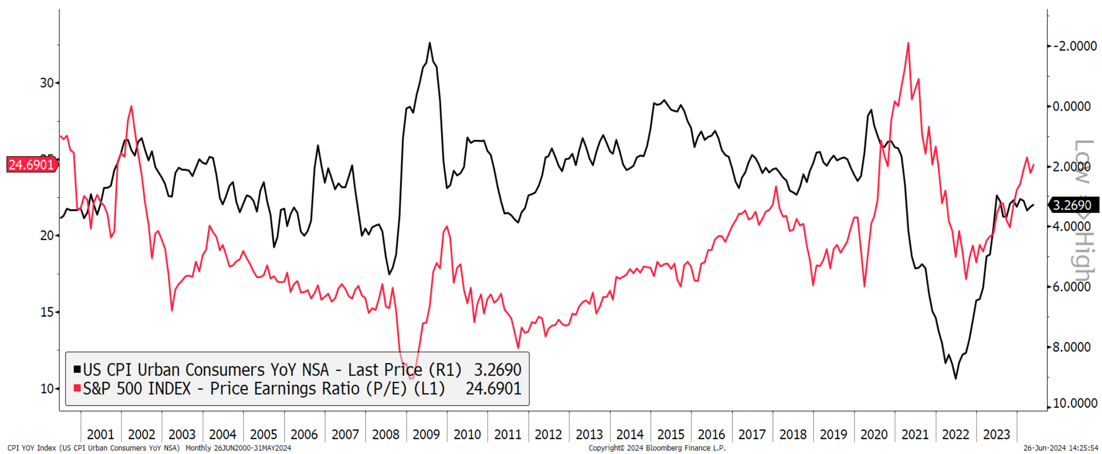


	CY10	CY11	CY12	CY13	CY14	CY15	CY16	CY17	CY18	CY19	CY20	CY21	CY22	CY23	CY24	CY25
Growth %	40.2%	12.8%	5.5%	5.2%	5.1%	-0.5%	0.9%	11.5%	20.3%	-0.1%	-10.2%	47.9%	4.0%	1.0%	11.3%	14.4%



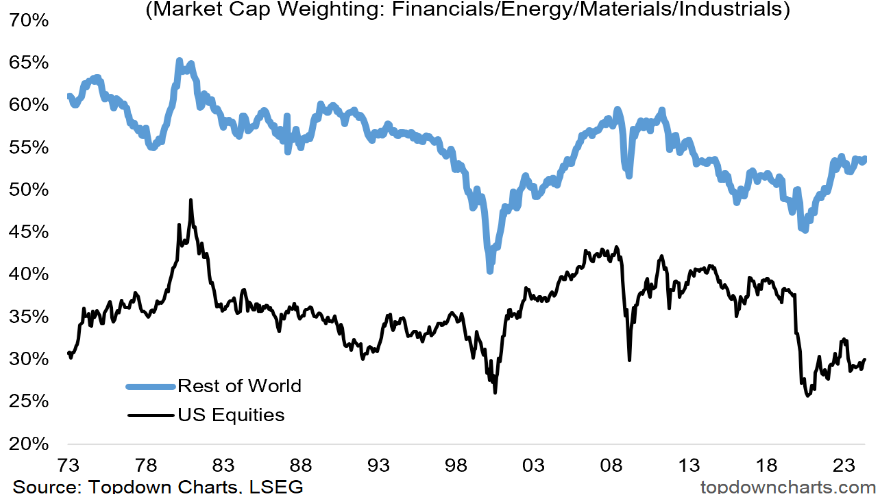
Other positive factors are disinflation and the start of the process of rate cuts by central banks. The graph below shows the inverse relationship between US inflation (inverted curve on the graph) and the PE ratio of the S&P 500. It is possible that US inflation will return below 3%. Between July and October, there will be a favorable comparison basis for energy prices. The historical 2023 PE ratio of 24x is fully justified and the multiples could even increase in the 2nd half of 2024. After assessing the level of the indices on the basis of an increase in profits, we could witness upward adjustments with an expansion of expected multiples.

US inflation (inverted curve) and PER S&P 500

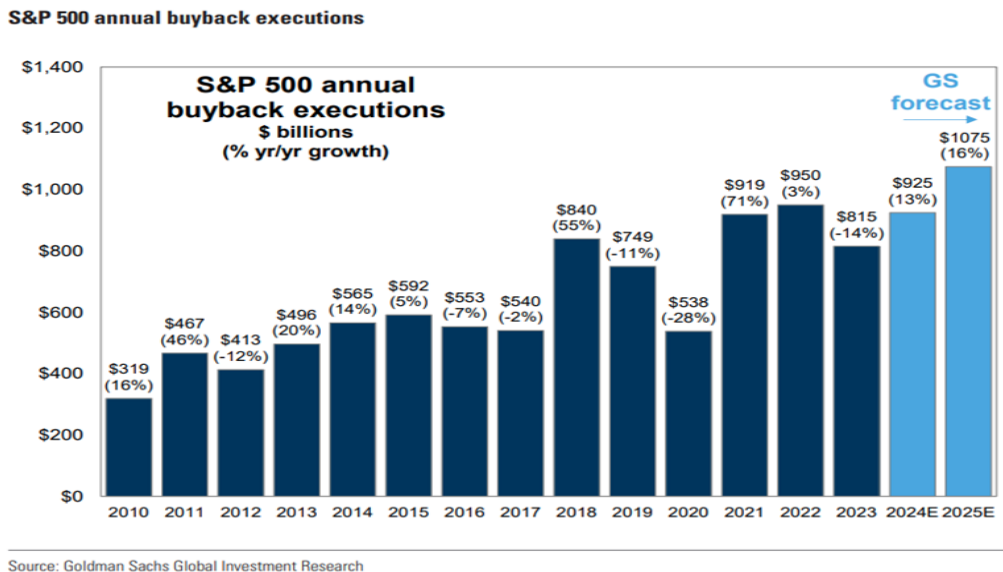


There is the debate on country allocation concerning the United States and the rest of the world. For our part, the US is mainly justified by its strong exposure to technology, The Magnificent 7, AI, etc., while for the Value/Cyclical part, the rest of the world, Europe and Japan in particular, warrant marked interest. The S&P 500 and the Nasdaq have outperformed thanks to Nvidia, Microsoft, Broadcom and other technologies, but Europe and Japan have outperformed since the beginning of 2023 the Dow Jones Industrial and the S&P 500 Equal Weighted (0.2% weight per stock) .

The weight of Value/Cyclical in the World ex-US index is 55% compared to 30% for the US index. Several themes justify Value/Cyclical, therefore Europe and Japan: reindustrialization, energy transition, defense, industrial metals.

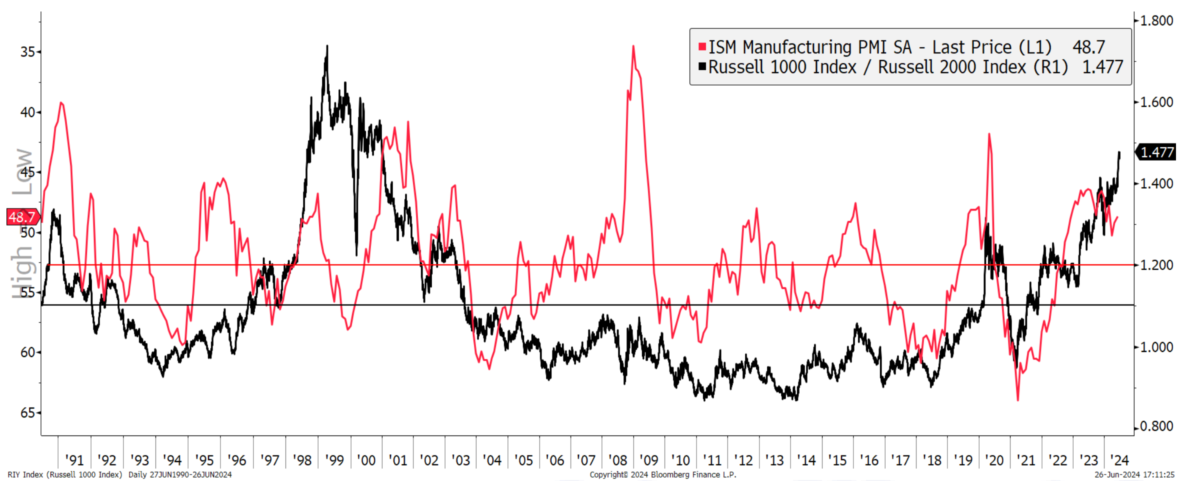


An extra boost from share buybacks



Since 2021, with one crisis after another, the small and medium-sized company segment has underperformed. There would need to be a real economic recovery for the trend to be reversed.

Russell 1000/Russell 2000 and US Manufacturing PMI (inverted)

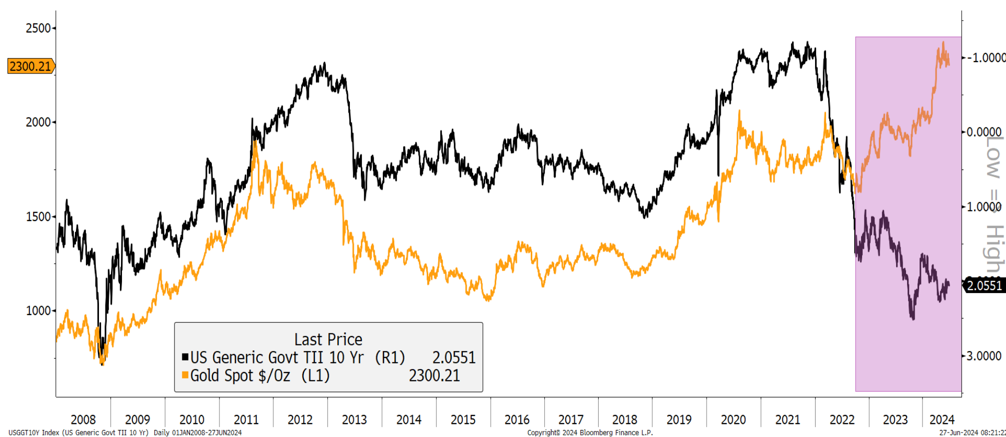


Commodities

Sluggish economic growth, pressure on prices

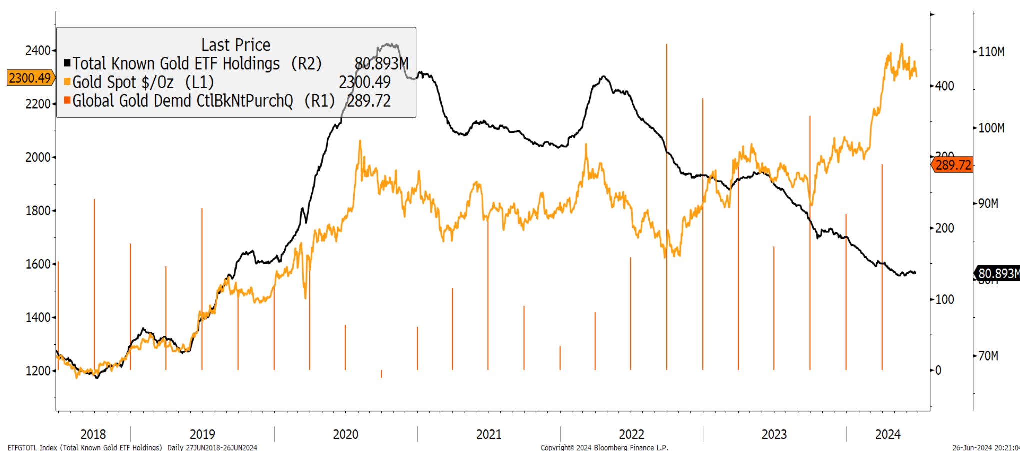
Since Fall 2022, the inverse relationship between gold and real interest rates no longer works. Real rates rose sharply, but the price of gold continued to rise. The reason: gold is a central banks' game. For almost four years, individual and institutional investors, sensitive to the gold/real rate relationship, have been exiting financial products invested in gold.

Gold price (yellow) and real rates (inverted)



The historical relationship between the price of gold and the holding of gold by individual investors through financial products also no longer works. Central banks purchase gold.

Gold price (yellow), gold holdings in ETFs (black) and gold purchases by central banks (red bars)



According to a recent World Gold survey, central banks will continue to increase the share of gold in their foreign reserves. The reasons: de-dollarization and de-globalization. For all gold buyers, geopolitics and wars speak in favor of gold. In the coming years, these three factors will probably weigh more in the balance than the historical factor of real interest rates. The outlook has softened for oil in the second half of 2024. Demand will be lower than estimated and Saudi Arabia will gradually increase its production. The rebuilding of stocks and the drop in refining margins argue for stable prices. The market expects an equilibrium price between $85-$90 for Brent. For 2025, analysts are more optimistic with the reconstitution of American strategic stocks and a probable peak in production in the United

States. After increasing by 42% between February 2024 and mid-May, the price of copper fell by 17%: after a significant Chinese restocking, total stocks are increasing and Chinese demand remains sluggish. Finally, it is difficult to anticipate the evolution of commodity prices, the global indices of which, the Bloomberg Commodity Index and the CRB, have evolved in a succession of rallies and corrections.

Bloomberg Commodity Index. Since 1980, the index fell by 27%

Unlike stocks, we cannot value raw materials whose prices depend only on demand and supply. Today, sluggish economic growth and disinflation justify falling prices. According to many analysts, the evolution of bitcoin is based on cycles around halving: bull phase, bear phase and consolidation phase. They estimate the return of a bull phase at the beginning of this fall.

Bitcoin's recovery phase seems to come to an end

Source: Hashdex Research with data from TradingView (accessed May 21, 2024). Past performance is not a guarantee of future results.

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